Ontario Energy Association

121 Richmond Street West, Suite 202
Toronto, ON M5H 2K1
416.961.2339
oea@energyontario.ca

February 2016

The Honourable Charles Sousa
Minister of Finance
c/o Office of the Budget
Frost Building South, 4th Floor
7 Queen's Park Crescent East
Toronto, ON M7A 1Y7

Dear Minister Sousa:

On behalf of the Ontario Energy Association's (OEA) Board of Directors and members, I would like to offer our appreciation for the opportunity to participate in Ontario's 2016 provincial pre-budget consultation process.

The Ontario Energy Association (OEA) aspires to be the most credible and trusted voice of the energy sector. We earn our reputation by being an integral and influential part of energy policy development and decision making in Ontario. We represent Ontario's energy leaders that span the full diversity of the energy industry.

Ontario continues to experience fiscal challenges. By removing barriers to the consolidation of Ontario's electricity local distribution companies (LDCs) the province can help mitigate future cost increases that are ultimately borne by energy customers, and also assist LDCs in upgrading infrastructure with the assistance of private capital. Bold policies have allowed Ontario to attract investment in generation infrastructure over the past several years and the province therefore enjoys sufficient supply to meet the energy demand needs of all customers. However, increased investment in the distribution sector is needed to ensure Ontarians continue enjoying access to an affordable and reliable supply of electricity, and now is the time to focus on providing electricity distribution services more efficiently to energy customers. The OEA believes that this can be achieved by incentivising LDC consolidation and removing barriers to private investment in LDCs.

We look forward to continuing the dialogue with your government on how changes to Ontario's energy sector can help create new investment opportunities in Ontario, generate savings for Ontario families and businesses, and continue repositioning the energy sector to support economic growth. If you have any questions regarding this submission please contact me or our Vice President of Government Relations and Communications, Tina Arvanitis at 647.920.3269 or tina@energyontario.ca.

Let's unravel the most complex energy challenges, together.

Best regards,

Bob Huggard
President and CEO
Ontario Energy Association

CC:
Mr. Scott Thompson, Deputy Minister of Finance
Hon. Bob Chiarelli, Minister of Energy
Mr. Serge Imbrogno, Deputy Minister of Energy
Hon. Brad Duguid, Minister of Economic Development, Employment, & Infrastructure
Mr. Giles Gherson, Deputy Minister of Economic Development, Employment, and Infrastructure
Mr. Philip Donelson, Office of the Premier
Mr. Ed Clark, Premier's Business Advisor
Mr. Bert Clark, Infrastructure Ontario

ONTARIO ENERGY ASSOCIATION

2016 PRE-BUDGET SUBMISSION

FEBRUARY 2016

To shape our energy future for a stronger Ontario.

Ontario Energy Association

ABOUT
THE OEA

The Ontario Energy Association (OEA) aspires to be the most credible and trusted voice of the energy sector. We earn our reputation by being an integral and influential part of energy policy development and decision making in Ontario. We represent Ontario's energy leaders that span the full diversity of the energy industry.

The OEA takes a grassroots approach to policy development by combining thorough evidence based research with executive interviews and member polling. This unique approach ensures our policies are not only grounded in rigorous research, but represent the views of the majority of our members. This sound policy foundation allows us to advocate directly with government decision makers to tackle issues of strategic importance to our members.

Together, we are working to build a stronger energy future for Ontario.

CONTENTS

PAGE TWO
EXECUTIVE SUMMARY

PAGE FOUR
RECOMMENDATION 1a:
WORK WITH THE FEDERAL GOVERNMENT ON LDC TAX ISSUES

PAGE SIX
RECOMMENDATION 1b:
FURTHER REDUCE TAX BARRIERS

PAGE SEVEN
RECOMMENDATION 2:
ADDRESS REGULATORY ISSUES

PAGE NINE
RECOMMENDATION 3:
AMEND INFRASTRUCTURE ONTARIO LOAN CONDITIONS

PAGE TEN
SUMMARY

EXECUTIVE SUMMARY

Rationalising Ontario's Electricity Distribution Sector to Address Rising Costs to Customers

The Ontario Energy Association (OEA) welcomes the commitment of the Government of Ontario to strengthen its fiscal management in an effort to pave the way to balanced budgets. The OEA's key contribution to Ontario's pre-budget process is to demonstrate how the energy sector can assist the government in meeting its overall policy objectives by ensuring affordable, reliable, and sustainable energy for Ontario consumers at the residential, commercial, and industrial levels. The importance of Ontario's energy sector cannot be underestimated:

- Ontario's electricity sector is an $18 billion annual industry[1] that employs approximately 95,000 people in the province, 65,000 of those directly[2]; and
- Natural gas distribution in Ontario is a $1.2 billion annual industry that directly employs over 4,300 Ontarians[3].

In order to help address some of Ontario's fiscal challenges, the OEA's 2016 pre-budget submission will focus primarily on means to **incentivise consolidation of electricity Local Distribution Companies (LDCs) by removing the financial and regulatory barriers to consolidation of, and private investment in, LDCs.**

Our recommendations would create new investment opportunities for energy companies, will generate savings for Ontario families and businesses, and will continue repositioning the energy sector to support economic growth.

1 Government of Ontario's Long-Term Energy Plan, 2013
2 Government of Ontario's Long-Term Energy Plan, 2010
3 Canadian Gas Association, 2013

RECOMMENDATIONS

INTRODUCTION

Over the last few years, Ontario's electricity LDCs have been given new obligations in addition to their core distribution business functions. For example, LDCs are connecting an increasing amount of renewable generation projects, meeting conservation and demand management (CDM) targets, and installing smart meters in Ontario homes. In addition, many LDCs are facing increasing capital demands owing to population growth, densification of urban centres, and ageing infrastructure.

In April 2012, the Ontario Minister of Energy established the Ontario Distribution Sector Review Panel (the "Panel") to provide expert advice to the government on how to improve efficiencies in Ontario's electricity sector with the aim of reducing the financial cost of electricity distribution for customers. In December 2012, the Panel delivered their report, Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First, that reviewed Ontario's electricity distribution sector and made many recommendations.

In 2014 and 2015 the OEA continued to advocate for consolidation in its presentations to the Premier's Advisory Council on Government Assets, where the OEA reiterated its views on removing regulatory and taxation barriers to LDC consolidation. The Premier's Advisory Council's recommendations on tax relief were an important first step in encouraging consolidation. The Ontario Energy Association looks forward to further action to address the regulatory barriers to industry change so that Ontarians can benefit from an efficient, reliable, and sustainable electricity system now and in the future.

In support of our advocacy of consolidation of electricity LDCs, the sub-sections below convey the OEA's recommendations to incentivise consolidation and remove barriers to private sector investment by addressing both regulatory and tax issues.

RECOMMENDATION 1a: WORK WITH THE FEDERAL GOVERNMENT ON LDC TAX ISSUES

The OEA recommends that the Government of Ontario work with the federal government to reintroduce *Public Utilities Income Tax Transfer Act*-style legislation.

LDCs that are at least 90% owned by a provincial or municipal government do not pay regular corporate income tax. Instead, the provincial and federal taxes that would be payable are remitted to the Ontario Electricity Financial Corporation / Province of Ontario as per sections 89, 90, and 93 of the *Electricity Act* and the *Income Tax Act* (Canada), section 149 (1). Ontario therefore receives both its own and the federal government's share of an LDC's tax payments.

However, should more than 10% of an LDC be acquired by a private entity(s), the LDC reverts to the normal federal and provincial corporate tax regimes, thus depriving Ontario of the payments in lieu of federal tax that it had previously been receiving. The recent sale of 15% of the shares of Hydro One is a good example of this: as a result of the IPO, Ontario lost the federal tax stream that had previously flowed to the provincial treasury.

To account for this lost revenue, Ontario imposes a transfer tax when an LDC is (semi-) privatized. This tax was previously 33% and has now been reduced for a three-year period. Although the tax holiday is expected to encourage LDC consolidation, it stands to reason that the lower the tax, the more consolidation and private investment will take place.

One way of balancing the province's need to maintain its existing revenue streams with LDCs' desires to see greater consolidation and private investment is through the reintroduction of legislation like the Public Utilities Income Tax Transfer Act, which was in force from 1966 to 1999. This federal legislation put privately and publicly owned utilities on the same footing by requiring that the federal government remit to the provinces 95% of the federal corporate income tax paid by privately-owned utilities. In other words, provinces would receive nearly all the taxes paid by private utilities, equal to what publicly-owned utilities pay, making provinces indifferent to whether utilities were privately or publicly owned.

Cooperation between the Government of Canada and the Government of Ontario is crucial to bringing about this solution, and the OEA is encouraged by recent collaboration between the federal and provincial governments. A new PUITTA-style law, applied on a going-forward basis to new utility privatization transactions, would

bring considerable benefits for Ontario – both in maintaining provincial revenue that would otherwise be lost in the Hydro One privatization and in the facilitation of LDC consolidation across the broader distribution sector.

RECOMMENDATION 1b: FURTHER REDUCE TAX BARRIERS

The OEA recommends that the Government of Ontario grant additional tax relief to LDCs in order to encourage consolidation transactions.

Should the provincial government succeed in implementing recommendation 1a and negotiate an arrangement with the Government of Canada to resolve the problem of tax leakage to the federal government, then the OEA would encourage the provincial government to further reduce – or completely eliminate – the transfer tax and departure tax for all LDCs.

The LDC transfer tax holiday announced in the 2015 provincial budget is meant to address industry concerns with the barrier to LDC consolidation/privatization erected by the transfer and departure taxes. The OEA is pleased that the government has taken action on reducing the financial barriers to consolidation and private investment by lowering the transfer tax from 33% to 22% or 0% (depending on LDC size) and exempting the capital gains portion of the departure tax that is triggered by the deemed disposition of assets on privatization. These changes only took effect in January 2016 and so while it is too early to determine the degree of consolidation that will take place as a result, the OEA is confident that these tax changes will contribute to a more positive investment climate in Ontario's electricity distribution sector.

Nonetheless, a 22% tax on larger LDCs (those with more than 30,000 customers) as well as the continued recapture of capital cost allowance (the other portion of the departure tax, for which no exemption has been granted) remain an impediment to the kind of consolidation and investment that the Ontario is seeking. **Municipally-owned electricity LDCs in Ontario have limited financial resources with which to invest in critical infrastructure, and these tax policy instruments continue to deter LDCs from attracting private capital or from seeking voluntary mergers with private entities, either of which could solve access to capital issues. Changing LDC tax policies in a manner consistent with Ontario's interest in eliminating the stranded Ontario Hydro debt would be a strong contributor to a healthier electricity distribution sector in the future, with greater capacity to deliver benefits to customers.**

RECOMMENDATION 2: ADDRESS REGULATORY ISSUES

The OEA recommends that the Government of Ontario rectify existing regulatory policies that discourage LDC consolidation.

In addition to the taxation issues discussed in recommendation 1, several regulatory issues must be addressed in order to better incentivise LDC consolidation. In some cases, tax relief alone may be insufficient to encourage consolidation to take place because of misunderstanding of the benefits of consolidation or local resistance to change. Moreover, existing economic distortions in the distribution sector caused by undesirable regulatory policies may in fact work against consolidation opportunities which might otherwise be seized more enthusiastically. Although the Ontario Energy Board is ultimately responsible for making the regulatory changes that would address these issues, the OEA is raising them in the context of our pre-budget submission in order to emphasize that **for LDC consolidation to happen, the government's existing tax changes must be accompanied by regulatory changes.**

The OEA had previously made five recommendations on resolving the regulatory barriers to consolidation. The OEB addressed two of those five items (the financial incentives for consolidation arising from the OEB's ratemaking process and the need for stability in capital structure and return on equity policies) in its March 26, 2015 report *Rate-Making Associated with Distributor Consolidation* and its January 22, 2016 supplemental report *New Policy Options for the Funding of Capital Investments*. These changes send a positive signal to industry about the OEB's intentions for regulatory reform, but from amongst the OEA's initial five regulatory recommendations the three most vital issues are still outstanding. **All of these regulatory recommendations are needed to effect the regulatory reform that would lead to greater LDC consolidation, and the OEA is therefore reiterating the three key regulatory barriers that must be addressed by the OEB:**

i. Equal Treatment of All LDCs Regardless of Size:
LDC regulation in Ontario has tended to reduce burdens on smaller LDCs as compared to larger LDCs, which has reduced the incentives for small LDCs to seek consolidation. OEB cost allocation policies, scrutiny of rate applications, required participation in OEB processes, accommodation of limited capacity to deliver on conservation priorities and other mechanisms should be reconsidered in light of systemic efficiency and incentives for consolidation. Efforts should be made to align the accountabilities of all LDCs towards the highest standards of regulatory excellence.

ii. Eliminating De Facto Subsidization of Electrically Embedded Utilities:

A number of small LDCs across the province receive all or much of their electricity at low voltages from other distributors, rather than maintaining their own connections to the province's transmission grid. The fees charged to such embedded distributors do not reimburse the providers for the fully loaded cost of the service, and are effectively much, much less than the cost of owning and operating a direct connection to the transmission grid. The result is that electrically embedded utilities can maintain customer rates which are much lower than the neighbouring utility that is providing low voltage power, therefore reducing the incentive to consolidate (consolidation would result in the loss of the effective subsidy, and therefore higher rates for customers). As long ago as 2004 the OEB recognized that electrically embedded distributors should not be present in the system, and banned the creation of any new such distributors. However, no action has been taken to eliminate or actively discourage the continued existence of pre-existing electrically embedded distributors.

iii. OEB Capacity to Efficiently Process Consolidation Transactions:
Over the past few years several consolidation transactions have been considered by the OEB, often requiring upwards of a year to process from the date of application. However, if the government eliminates barriers to consolidation, the OEB could be faced with a comparative flood of transaction applications, potentially leading to disastrous delays in transaction execution. It is imperative that the OEB be prepared with a full complement of Board members, a cadre of knowledgeable staff who can address applications, and a streamlining of the policies and procedures to efficiently review transactions.

The OEA would like to emphasize that tax relief alone is not sufficient: the regulatory issues described above must all be addressed in order to better incentivise LDC consolidation. This is because in some cases, tax relief alone may be insufficient to overcome misunderstanding of the benefits of consolidation or local resistance to change. Moreover, existing economic distortions in the distribution sector caused by undesirable regulatory policies may in fact work against consolidation opportunities that might otherwise be seized more enthusiastically. Thus, it is only a combination of both regulatory changes and tax relief that will lead to LDC consolidation in this province.

RECOMMENDATION 3: AMEND INFRASTRUCTURE ONTARIO LOAN CONDITIONS

The OEA recommends that the Government of Ontario allow Infrastructure Ontario loans to municipally-owned LDCs to be held through to maturity without penalty, even if the LDC is partially privatized.

As Eligible Public Organizations under the Ontario Infrastructure and Lands Corporation Act, 2011 ("the Act"), many LDCs, including a number of OEA members, hold loans issued by Infrastructure Ontario. However, section 4. (2), para. 3 of the Act requires that all the shares of the LDC be held by one or more municipal corporations in order for the LDC to be eligible for an Infrastructure Ontario loan. In the event that an LDC becomes ineligible during the loan term (e.g. should some of its shares be acquired by a private entity), Infrastructure Ontario rules specify the LDC must repay its outstanding debt plus a penalty charge.

The Government of Ontario has announced measures to encourage the consolidation and the investment of private capital in Ontario's local electricity distribution companies (LDCs), including the temporary reduction of the taxes payable on the transfer of municipally-owned LDCs to private owners. The enforcement of Infrastructure Ontario's loan conditions as they currently stand would entail significant penalty payments for the municipal LDCs that are the very subjects of the government's consolidation and investment efforts; in addition, the cost of these penalties would likely be passed through to electricity consumers.

The OEA believes that this consequence is both unintended and entirely avoidable, and therefore recommends that the Government of Ontario direct Infrastructure Ontario to exempt the loans currently held by LDCs from immediate repayment and penalties should those utilities become parties to a consolidation or privatization transaction. **The OEA understands that this proposal is supported by Infrastructure Ontario.**

SUMMARY

Recommendation 1a: Work with the Federal Government on LDC Tax Issues

The OEA recommends that the Government of Ontario work with the federal government to reintroduce Public Utilities Income Tax Transfer Act-style legislation.

Recommendation 1b: Further Reduce Tax Barriers

The OEA recommends that the Government of Ontario grant additional tax relief to LDCs in order to encourage consolidation transactions.

Recommendation 2: Address Regulatory Issues

The OEA recommends that the Government of Ontario rectify existing regulatory policies that discourage LDC consolidation.

Recommendation 3: Amend Infrastructure Ontario Loan Conditions

The OEA recommends that the Government of Ontario allow Infrastructure Ontario loans to municipally-owned LDCs to be held through to maturity without penalty, even if the LDC is partially privatized.

energyontario.ca

CONTACT

121 Richmond Street West
Suite 202
Toronto, Ontario M5H 2K1
416.961.2339
oea@energyontario.ca
@energyontario
energyontario.ca

OEA
Ontario Energy Association

Let's unravel complex energy challenges, together.